No. 12850.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

JOSEPH G. WHITE,

Appellant,

vs.

FRANCIS F. QUITTNER, Trustee in Bankruptcy in the Estate of Al Herd, Bankrupt,

Appellee.

APPELLANT'S OPENING BRIEF.

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Preliminary Statement.

Joseph G. White, appellant herein, was respondent below, and, for convenience, will be hereinafter referred to as "White." This case grows out of a legal action instituted in the California State Court by one George L. Gibbons against White, which action is hereinafter referred to as "the Gibbons suit." While the Gibbons suit was pending against White, the trustee in bankruptcy, appellee herein, made a deal with Gibbons whereby the trustee became the real party in interest as plaintiff in the Gibbons action. The trustee did not reveal this fact to White so as to prevent White from having an opportunity to assert defenses available against the

trustee. The purpose of the trustee is described by his attorneys in their petition for fees, as follows:

> "Preferring not to bring about a change in parties in the Gibbons suit against White by substitution of the trustee as plaintiff (with consequent danger of affording White an opportunity to offset claims assertable against the trustee but not against Gibbons), petitioners elected to continue the action in the name of Gibbons and to have the trustee take an assignment of the entire proceeds which may be recovered in said action." [Quotation from an allegation of White, appearing at p. 10 of the Transcript, which allegation was admitted by the trustee at p. 16 of the Transcript.]

After discovery of the facts by White, the matter was brought to the attention of the bankruptcy court, which held that White should not have been so denied an opportunity to assert his claims, but that he was not prejudiced thereby, because he had no valid claim to assert. White here appeals on the ground that he was prejudiced because he did have a valid claim to assert against the trustee, as set forth in detail herein.

AUTHORITY FOR JURISDICTION OF THIS COURT.

U. S. C. A., Title 11, Sec. 47;

Coursey v. Internat'l Harvester, 109 F. 2d 774, 779.

Statement of the Case.

(White has not raised any issue in this appeal as to whether the Findings of Fact are supported by the evidence and no references will be made to any evidence. All references supporting statements of fact will be to the Findings of Fact.)

For a considerable period prior to these bankruptcy proceedings, Herd, the bankrupt, was borrowing money from one George Gibbons [Tr. p. 35]. About 3 months before bankruptcy proceedings were started, Gibbons brought action against the bankrupt to collect on said loans and attached the bankrupt's property [Tr. p. 35]. Several weeks thereafter White, as gratuitous accommodation to the bankrupt gave Gibbons a 30 day accommodation note in the sum of $5,000 [Tr. p. 35]. At or about this same time White, as a further accommodation to the bankrupt, gave Morris Plan Bank his note for $25,000 and the bankrupt gave White a $30,000 non-negotiable note as evidence of the bankrupt's liability to White on the aforesaid two accommodation notes [Tr. p. 42].

At the date of bankruptcy, August 6, 1947, no payments had been made on any of the foregoing notes and Gibbons was the owner and holder of White's $5,000 accommodation note [Tr. p. 42].

One week after bankruptcy Gibbons commenced action (the Gibbons suit) in the Superior Court in and for the County of Los Angeles to collect on White's aforesaid accommodation note [Tr. p. 35]. Gibbons was represented in said action by the law firm of Jones & Wiener. While the Gibbons suit was pending against White, the

trustee brought an action against Gibbons in the United States District Court. This action was based on two claims: first, the trustee claimed that the aforesaid $5,000 note delivered to Gibbons was a preference, and second, the trustee claimed that the aforesaid loans by Gibbons to the bankrupt were at usurious rates of interest [Tr. p. 36].

In May of 1948 the trustee made a settlement with Gibbons whereby it was agreed that Gibbons would waive a claim in the sum of $19,500 which he had filed against the estate, pay the trustee $3,000 in cash, and that the trustee should have all of Gibbons' right, title and interest in the aforesaid $5,000 note [Tr. pp. 36 and 38].

The trustee then prosecuted the Gibbons action for his own benefit. The trustee, so as to avoid affording White an opportunity to assert possible claims which might have been assertable against the trustee, but not against Gibbons, did not disclose to White the interest of the trustee in said $5,000 note or in the Gibbons action [Tr. p. 36]. The trustee's failure to disclose his interest in said action prevented White from asserting claims which may have existed in his favor against the trustee, and White was entitled to have an opportunity to assert said claims [Tr. p. 44].

The attorneys for the trustee had themselves substituted for Jones & Wiener as attorneys for Gibbons and on or about July 15, 1948, ostensibly as attorneys for Gibbons, but actually as attorneys for the trustee, secured a summary judgment against White in the Gibbons action [Tr. p. 39]. Said judgment was for the $5,000, plus attorney's fees and costs, or the total sum of $6,220, which White paid [Tr. p. 40] without having acquired

any knowledge of the trustee's interest therein [Tr. p. 43].

White then acquired knowledge that the trustee had been the real party in interest in the Gibbons action and that he had been deprived of his right to assert claims against the trustee therein. Upon White's assertion of this fact, the trustee initiated the proceedings which are now before this court as set forth in the following paragraphs.

Pleadings Disclosing Jurisdiction.

This matter was initiated by an Order to Show Cause [Tr. p. 5] issued by the Referee in Bankruptcy herein upon the Petition of the Trustee herein [Tr. p. 3]. The Order to Show Cause directed White to set forth any claims which he may have to any funds in the hands of the trustee. White set forth a claim to a sum of $6,220, then in the hands of the trustee, by an Amended Answer to Order to Show Cause [Tr. p. 7]. The trustee then joined issue by filing Trustee's Reply to Amended Answer of White in Proceedings to Quiet Title [Tr. p. 13.]

A hearing was had before the Referee upon the foregoing pleadings and, after oral and documentary evidence had been received by him, he decided that White had no interest in said sum of $6,220 and made Findings of Fact [Tr. p. 35] and Conclusions of Law [Tr. p. 44] and an order based thereon [Tr. p. 45] dated April 5, 1950.

On April 14, 1950, White filed a Petition for Review [Tr. p. 46] and on June 22, 1950, the Referee filed his Certificate on Petition for Review [Tr. p. 51].

A hearing was then had before the Hon. Benjamin Harrison, Judge of the United States District Court for the Central Division of the Southern District of California, and by an order [Tr. p. 60] dated December 4, 1950, the District Court adopted the aforesaid Findings of Fact and Conclusions of Law of the Referee and affirmed the Referee's decision.

On January 2, 1951, White filed a Notice of Appeal [Tr. p. 62] and Statement on Cash Deposit [Tr. p. 63]. On January 11, 1951, White filed a Statement of Points on Which Appelant Intends to Rely on Appeal [Tr. p. 64] and a Designation of the Portions of the Record to Be Contained in Record on Appeal [Tr. p. 65] in the District Court and subsequently a similar Statement of Points Upon Which Appellant Intends to Rely and Designation of the Record were filed in this court.

Specification of Errors.

1. It was error of law for the court below to conclude that White had no right to recoupment against the trustee.

2. It was error of law for the court below to hold that the settlement made between the trustee and Gibbons did not have the effect of discharging the $5,000 note.

Argument re Recoupment.

Recoupment is defined in the case of *Howard Johnson v. Tucker,* 157 F. 2d 959, where the court states:

> "Recoupment is the act of rebating or recouping a part of a claim upon which one is sued by means of a legal or equitable right resulting from a counterclaim arising out of the same transaction. 57 Corpus Juris, Setoff and Recoupment, Sec. 1. It differs from a setoff, in that 'A setoff is a counter demand which a defendant holds against a plaintiff arising out of a transaction extrinsic of plaintiff's cause of action.' *Id.* Sec. 2. Setoff is of statutory origin and depends for application generally on statutory provisions. *Id.* Sec. 3 and ff. Recoupment exists at common law and in equity and rests on the justice of settling both sides of a transaction at once as a mutual matter."

Recoupment is also explained in the case of *Crossett Lumber Co. v. U. S.,* 87 F. 2d 930, where the court says:

> "The ordinary subject-matter of recoupment is a claim arising directly from the particular contract sued upon. Familiar examples are where the defendant in an action to recover the purchase price of goods sold with warranty sets up in defense a breach of warranty, *C. Aultman & Co. v. Torrey,* 55 Minn. 492, 57 N. W. 211, or where in an action to foreclose a purchase money mortgage the defendant recoups because of the vendor's fraud in inducing the purchase. *Kaup v. Schinstock,* 88 Neb. 95, 129 N. W. 184; *Williams v. Neely* (C. C. A. 8), 134 F. 1, 69 L. R. A. 232. Recoupment, however, is not necessarily so limited. In *Ward v. Alpine Tp.,* 204 Mich. 619, 171 N. W. 446, 450, in an action *in*

assumpsit against a township for the conversion of materials which had been furnished by plaintiff in the construction of a bridge, it was held that the defendant could recoup for damages sustained by reason of the plaintiff's nonperformance of the contract. That case contains the following quotation from Waterman on Setoff and Recoupment (2d Ed.), p. 480, as to how recoupment is distinguished from setoff: 'First, in being confined to matters arising out of, and connected with, the transaction or contract upon which the suit is brought; second, in having no regard to whether or not such matter be liquidated or unliquidated; and third, that the judgment is not the subject of statutory regulation, but controlled by the rules of the common law. * * * It is sufficient that the counterclaims arise out of the same subject-matter, and that they are susceptible of adjustment in one action.'"

In the case of *Mills v. United States,* 35 Fed. Supp. 738, 739, it was said that:

> "The doctrine of recoupment is not limited to a claim arising directly from the particular contract sued upon. It is sufficient if it arises out of the same subject matter, and that the claims are susceptible of adjustment in one action."

Recoupment is not limited by Section 68, or any section, of the Bankruptcy Act and the doctrine applies in suits by or against a trustee in bankruptcy to the same extent and in the same manner as in other cases. This is

pointed out in the two standard treatises on bankruptcy as follows:

Collier on Bankruptcy, 14th Ed., Sec. 68.03:

> "Certainly in any suit or action between the estate and another, the defendant should be entitled to show that because of matters arising out of the transaction sued on, he is not liable in full for the plaintiff's claim. There is no element of preference here or of an independent claim to be offset, but merely an arrival at a just and proper liability on the main issue, and this would seem permissible without any reference to Sec. 68."

Remington, Vol. 4, 5th Ed., Sec. 1435:

> "Setoff must be distinguished from recoupment. The rule that property passes to the trustee subject to the equities enables a claim in recoupment to be asserted by or against him. Section 68, 11 U. S. C. A., Sec. 108, is not involved."

The rule is also pointed out in the matter of *In re Monongahela Rye Liquors,* 141 F. 2d 864, at p. 869, where the court said:

> "And in *Bull v. U. S.,* 295 U. S. 247, it is said (295 U. S. p. 262, 55 S. Ct. 700, 79 L. Ed. 1421) that 'recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded.' The rule of recoupment in bankruptcy derives from the rule that the trustee takes the bankrupt's property subject to the equities therein. It does not attach by reason of the setoff provisions of Sec. 68, sub. a. 4 Remington on Bankruptcy, 5th Ed., Sec. 1435."

A defendant is entitled to make a recoupment wherever his claim arises out of the same subject or matter as that upon which the plaintiff bases his claim. Here the trustee based his claim against White upon a $5,000 note. White's claim in recoupment is based on his rights as accommodating party on the same $5,000 note. Both claims arise out of the same subject matter. Because this note was an accommodation note it might be well to make a brief general statement concerning the nature of accommodation paper:

> "Accommodation paper is a bill or note to which the acceptor, drawer, maker or endorser has put his name without consideration for the purpose of accommodating by a loan of his credit some other person who is to provide for the bill or note when it falls due."
>
> 11 *C. J. S.* 286.

> "An accommodating party is one who has signed the instrument as maker, drawer, acceptor or endorser without receiving value therefor and for the purpose of lending his name to some other person."
>
> 11 *C. J. S.* 287.

> "An accommodated party is one to whom the credit of the accommodating party is loaned."
>
> 11 *C. J. S.* 292.

> "Both at common law and under the negotiable instruments act the party for whose benefit accommodation paper has been made acquires no rights against and is not entitled to sue the accommodation party, the absence of consideration being a defense to such an action."
>
> 11 *C. J. S.* 300.

"Where a bill or note has been made, accepted or endorsed for the benefit of one of the members of the firm, the firm, although purchasers for value before maturity, cannot maintain an action thereon against the accommodation party because the position of the firm can be no better than that of the partner who is the accommodated party."

11 *C. J. S.* 302.

"The receiver [of a bank] is not entitled to recover on a note executed for the accommodation of the bank."

Bosworth v. Cady, 72 F. 2d 62.

There was but one subject matter involved in the Gibbons action and that was Gibbons' financing of the bankrupt. Gibbons was foreclosing on the bankrupt, and White gratuitously came to the bankrupt's aid with an accommodation note. The bankrupt, and not White, was the party ultimately liable on the note. When bankruptcy ensued, the trustee found that at the time the note was given, Herd was not indebted to Gibbons, and in fact that Gibbons was indebted to the bankrupt because of usury. Gibbons recognized these facts and disgorged his ill-gotten gains, including the accommodation note, to the trustee. Under such circumstances can it be said that White is indebted to the trustee? Or that the trustee's interest in the note and White's right to have the note paid by the accommodated party do not arise out of the same subject matter?

The Referee's Conclusion of Law on this point [Tr. p. 44], adopted by the District Court, emphasized that the matters asserted by White and the trustee's claims were

not "mutual debts or mutual credits." But mutuality is a requirement of Section 68 of the Bankruptcy Act which clearly has no application to a claim in recoupment—the only requirement for such a claim in recoupment being that it arise out of the same subject matter as the plaintiff's claim.

Since White contends, and it has been found by the court below, that White was prevented by the trustee from urging his claim in the California State Court, his rights of recoupment under the State law should be considered. The State and Federal rules are the same. The California law is plain that a defendant is allowed to recoup on account of any claims arising out of the same transaction as that upon which plaintiff's action is based. In *Stern v. Sunset Road Oil Co.,* 47 Cal. App. 334, 341, the court says:

> "We have then a case where the cause of action of the plaintiff on the assigned demands for the delivery of current use oil, and the right of the defendant to recoup on account of the $60,000 advanced to plaintiff's assignor for development purposes, grew out of and had their origin in the same subject matter and in the same contract. Under such circumstances recoupment was proper."

It should also be noted that the right of recoupment is available against an assignee and was allowed against an assignee in the *Stern v. Sunset Road Oil Co.* case, *supra.*

The doctrine of the *Stern* case was followed in *Bank of America v. Pac. Ready Cut Homes,* 122 Cal. 554, 564, where the court said:

> "Appellant contends from that fact that, at the time of said assignment, respondent had no claim

against Frey under this Baileys contract and, therefore, there was an indebtedness against Frey in favor of respondent, arising out of the Baileys contract, existing at the time of or before notice of assignment, and that appellant therefore took the assignment free from any such claim.

"However, the trial court found 'that said contract between the defendant and said E. R. Frey was in writing bearing the date the said 9th day of May, 1928, but the writing comprised two separate instruments, one relating to the two houses and two garages at Vestal, California, . . . and the other writing referring to the house and garage at Baileys, California; that the two instruments together comprise but a single contract . . . and that it was not intended by defendant and said E. R. Frey that said separate writings should constitute separate and divisible contracts between themselves.' In view of this finding, although Frey assigned to appellant only that portion of the contract relating to the Vestal job, still that assignment would be subject to the recoupment arising out of the Baileys job, for we have then a case in which the appellant's cause of action on the assigned Vestal contract, and the right of respondent to recoup for the expense of completing the Baileys job, both grew out of the same subject matter and the same contract. Under such circumstances there could be no doubt of respondent's right of recoupment for expenses in completing the Baileys job."

In the case at bar, the trustee's wrongful concealment of his interest in the Gibbons action prevented White from making recoupment against the trustee.

The doctrine of recoupment is one which is applied on the basis of equity and fair dealing. Thus, in the case of *Howard Johnson v. Tucker,* 177 F. 2d 959, the court allowed a defendant to recoup against a trustee in bankruptcy. There the trustee was suing to recover the sum of $10,000 which the bankrupt had deposited with one Locar Inc., the lessor of certain property. The lessee of the property was Howard Johnson, who in turn sublet it to the bankrupt. The bankrupt had put up the $10,000 because Locar, Inc. had refused to make certain improvements until that sum was put up to guarantee payments by Howard Johnson. The bankrupt defaulted in its rental payment to Howard Johnson and Howard Johnson defaulted in its payment to Locar, Inc. After bankruptcy, Locar, Inc. used $1,500 of the $10,000 to apply on past due rent and used the balance of $8,500 to apply on future rentals which were accelerated by the default. Howard Johnson urged in recoupment its claim against the bankrupt because of past due rents and because of breach of agreement to pay future rents. In allowing recoupment the court said (p. 961):

> "It would be unjust and inequitable to separate these mutual inchoate obligations in an accounting between these parties. This is true not only as to rents accrued at bankruptcy, but also as to the damages which the Bankruptcy Act substitutes for future rents on rejection of the lease by the trustee in bankruptcy. The petition here asserts that this lease was promptly disclaimed by the trustee on May 2, 1942, a month after the escrow check was used. The claim for damages thus arising is as proper a counterclaim in the settling of this business as the rents accrued, and they ought to be ascertained in the

accounting. The amount of damages for the rejection of the lease by the trustee ought to be limited as it is in the Bankruptcy Act, 11 U. S. C. A., sec. 103, sub. a. But when the damage is ascertained, *because the obligation breached arises out of the same transaction as that on which the trustee is suing, it is not a separate unsecured claim against the estate, but a recoupment which may be defensively asserted in this plenary suit by the trustee.*" (Emphasis supplied.)

Certainly it would be unjust and inequitable to make White pay the sum of $5,000 to the trustee herein because of a transaction wherein it was agreed by Herd that the obligation was Herd's and not White's and where White gratuitously lent his credit to Herd to hold off Gibbons, and it was later discovered that Gibbons owed Herd nothing. The plain facts are that Gibbons claimed Herd owed him money. White lent Herd his credit to hold off Gibbons. Bankruptcy ensued and the trustee established that Gibbons' claim was unjustifiable and in fact he owed Herd money. This piece of business cannot equitably result in White's being liable to the trustee.

Argument re: Discharge of the Note.

As has been set forth above, the promissory note in question was made by White as an accommodation for the bankrupt and delivered to Gibbons. The note was received by the trustee without endorsement in connection with the settlement of the trustee's action against Gibbons. Since the note was for the accommodation of the bankrupt, as between White and the bankrupt, the bankrupt was the party primarily liable thereon, and, since

this liability of the bankrupt was enforceable against the trustee, as between White and the trustee, the trustee was the party primarily liable thereon.

> "When a note is paid after maturity by one who is a co-maker, surety, or otherwise primarily liable for the obligation, the indebtedness is extinguished and a suit based on that instrument may not thereafter be maintained." (*Gordon v. Wansey,* 21 Cal. 77; *Harris v. King,* 113 Cal. App. 357; *Crystal v. Hutton,* 1 Cal. App. 251; *Dodds v. Spring,* 174 Cal. 412.)
>
> "A different rule, however, prevails when the note is fully paid by a stranger thereto who is not obligated by the terms of the instrument."
>
> *Proctor v. Pyle,* 33 Cal. App. 2d 121, 130.

Clearly the trustee was not a stranger to the instrument in question and was not one who was not obligated by the terms of the instrument.

An analogous case is *Harris v. King,* 113 Cal. App. 357, where there were two co-makers on a note, one of whom accommodated the other. The accommodating party "purchased" the note from the payee and it was endorsed to him "without recourse." It was there held that such a "purchase" extinguished the note. The rule laid down is that performance by the obligor cannot be a purchase.

The rule is also enacted in Section 3200 of the Civil Code of the State of California, as follows:

> "Sec. 3200. Instrument; how discharged. A negotiable instrument is discharged—
>
> (1) By payment in due course by or on behalf of the principal debtor;

(2) By payment in due course by the party accommodated, where the instrument is made or accepted for accommodation;

(3) By the intentional cancellation thereof by the holder;

(4) By any other act which will discharge a simple contract for the payment of money;

(5) When the principal debtor becomes the holder of the instrument at or after maturity in his own right. (Added by Stats. 1917, p. 1549.)"

A note is discharged where payment is made by or on behalf of an accommodated party. The rule is set forth in 19 Cal. Jur. 920, as follows:

" 'A negotiable instrument is discharged by payment in due course by or on behalf of the principal debtor.' This is made the rule by the uniform law and is identical with the rule of the law merchant and the common law in regard to the extinguishment of obligations generally. It is settled that payment at or after maturity by one of several makers, or by a surety on behalf of the makers, or by a third person at the request of the maker, or by or on behalf of an accommodated party, extinguishes the obligation, and no action may be brought upon the instrument itself nor is it thereafter a subject of sale or transfer so as to vest in the transferee any right to sue upon it."

Conclusion.

The trustee deliberately concealed his interest in the Gibbons action so as to prevent White from asserting any possible claims that he may have had against the trustee. This was definitely determined by the referee and the District Court, and no appeal has been taken from that determination.

White lent Herd his credit so as to hold off one of Herd's creditors. In effect White agreed that if Herd did not pay this creditor, White would make the payment. White guaranteed Herd's payment to Gibbons. When bankruptcy ensued, it was determined that the obligation which White had guaranteed was non-existent, and neither reason nor justice supports the decision below that White is now obligated on this guarantee.

It is respectfully submitted that the judgment should be reversed and the trustee ordered to pay White the sum of $6,220.

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